Czech National Bank preview: Hawks are demanding more rate hikes

We fully expect the CNB to raise rates by 75bp next week and there'll be more to come. We believe inflationary pressures will trump stagflation risks. That said, any hawkish decision is likely to be accompanied by a more dovish emphasis on geopolitical risks which could open the door for future interest rate stability

Source: Shutterstock

+75bp Change in the key rate

ING forecast

CNB internal forecast should show higher rates again

The Czech National Bank will hold its first monetary policy meeting since the outbreak of the Ukrainian war next Thursday; the conflict's largely silenced the central bank for some time. However, recent statements by the board suggest that little has changed in the CNB's thinking and higher inflation simply calls for higher interest rates. We expect the discussion to be in the 50-100bp range. However, our base case scenario sees a 75bp hike in the key rate to 5.25% and there's an increased risk of more rises to come.

Inflation surprised to the upside again in February (11.1% YoY) versus the CNB forecast (9.7% YoY). That said, core inflation was only slightly above that forecast as most of the surprise came from food and fuel prices. It's worth noting that those numbers came before the full impact of the Ukraine conflict became known. We don't think there'll be a new CNB forecast at the March meeting but we believe that internal projections will show inflation peaking around 14% Year-on-Year in May or June. While we should see some slowing in the annual pace in the second half of the year, the CBN will be happy if inflation falls back below 10% by the end of the year.

The risk of stagflation is not a game changer for now

GDP growth in the fourth quarter of last year was more or less in line with the CNB's forecast, but the main issue at the moment is the impact of the war on the Czech economy. It is clear that the downside risk is highly significant for the second and third quarters and full-year growth will be revised into the 0-1% range. However, for now, the forecast does not seem to have hit the pain threshold of the Board, which, according to recent statements sees a risk of stagflation only for this year, and next year the economy should return to growth territory. So, inflation remains the main indicator of the Board's attention, which we believe will lead to a confirmation of the current hawkish line at next week's meeting.

FX intervention is a tool of last resort

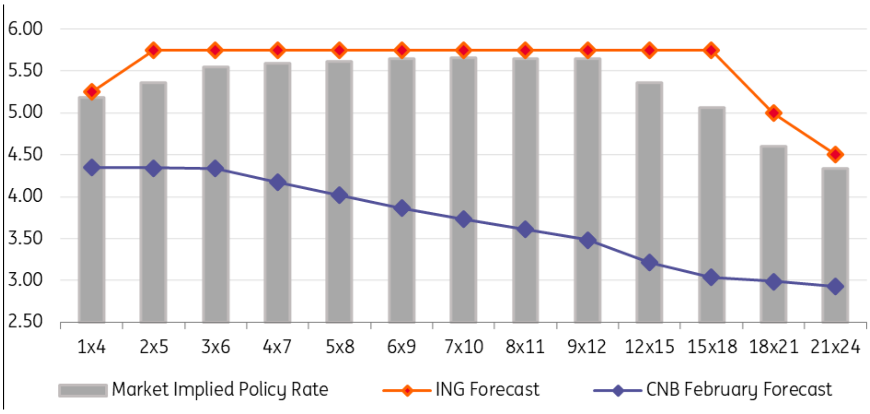
In response to the sharp depreciation of the koruna in the first days of the Ukrainian conflict, the CNB announced FX interventions to "mitigate excessive fluctuations and depreciation of the koruna". Since then, EUR/CZK has recovered from 25.80 to the current 24.60, not far from this year's lows, while showing the biggest recovery among CEE peers. However, the daily CNB data only shows normal banking sector liquidity volatility, implying minimal or no FX market activity from the central bank side.

This was also confirmed by governor Jiří Rusnok in a recent interview although he admitted that he expects a discussion on FX tools and their use at the March meeting. However, other bank members (Holub, Mora) were more hostile about the broader use of massive FX reserves in an attempt to push the koruna to stronger levels. For now, we believe that FX intervention remains only a backup tool if we see a further escalation in the Ukraine war and a sharp depreciation of the koruna towards 26 per euro, which is not our base case scenario.

Expect more hikes before any move to cut rates

Although the CNB's new forecast will not be published until May, the main question for this meeting is what comes next and where is the pain threshold between economic growth and record inflation of this millennium? We believe that March's rate hike is not the last and we should see at least one more this year. Given the inflation profile and the sensitivity of the CNB Board to spot inflation, we expect another 50bp rate hike in May. Given the Ukrainian uncertainty and inflation's future path, the door remains open for further CNB action. We see the terminal key rate at 5.75%, which is 25bp higher than previously.

Czech FRA curve expectations



Source: Macrobond, ING

What to expect in FX and rates markets

Although we think the Board's decision will be strongly hawkish, the overall tone may not be so clear given market expectations. We expect Governor Rusnok to emphasise the risks associated with the Ukraine conflict and the open door for any possible next steps by the CNB, including interest rate stability, which may lead to market disappointment. Nevertheless, we expect further growth in spot inflation to maintain a hawkish tone at least for the May meeting. Although the market is currently almost in line with our expectations, a temporary dip in the FRA curve may once again be a good entry point for payers.

The long end of the curve is pricing CNB rate still slightly below 3%, which leaves room to the upside, but it is clear that we are nearing a peak here just like the short end of the curve. In the FX space, EUR/CZK is reestablishing its relationship with the market rate differential and gradually erasing the risk premium, however, we believe a return to pre-Ukraine conflict levels is a bumpy road with a lower EUR/USD and potential geopolitical escalation.

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